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NATIONAL SECURITY COUNCIL
WASHINGTON, D.C. 20506

February 24, 1982

Executive Registry

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MEMORANDUM FOR Nancy Bearg Dyke
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NSC Review Completed.

Executive Secretary
Central Intelligence Agency

State Dept. review completed

Dennis Whitfield
Executive Assistant to the USTROffice of the Chairman
Council of Economic AdvisersSUBJECT: Senior Interdepartmental Group Meeting
re the Versailles Summit, March 4, 11:00 a.m.

Pursuant to NSDD-25 on preparations for the Economic and NATO Summits, Robert Hormats, the President's Personal Representative for the Economic Summit, will chair a meeting of the Senior Interdepartmental Group for the Versailles Summit preparations on Thursday, March 4, 1982, at 11:00 a.m., in the Old Executive Office Building, Room 305. He will at that time review the strategy and theme papers that have been prepared thusfar (see attachments) and report on the results of the preparatory meeting in Paris on February 27-28, 1982.

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- 2 -

Representatives of the various agencies should be at the Under Secretary level. The NSC staff contact for this meeting will be Henry Nau (395-6961).

Michael O. Wheeler

Michael O. Wheeler
Staff Secretary

Attachments

- A Strategy Paper for Versailles Economic Summit
- B U.S. Trade Objectives at the Versailles Summit
- C Context of the Energy Security Initiative
- D East-West Economic Relations at the Versailles Summit
- E Initial U.S. Letter to the French with our Suggestions for Theme and Issues at Versailles

June 4, 5, 6, 1982

The Annual Economic Summit takes place on June 4, 5, 6 in Versailles, France. This Summit is the eighth and the first of a new round of Economic Summits. Each country has now hosted one of these meetings. Versailles takes us back in a sense to Rambouillet, the first Economic Summit. It offers us an opportunity to reconsider the purposes of these annual meetings, which have now become semi-fixed features of the international economic system since the breakdown of the fixed exchange rate system and the oil crises of the 1970s. It also sets up the themes for the following year of economic events and the 1983 Annual Summit which the United States will host. And it occurs this year in connection with a NATO Summit, which takes place two days later on June 9, 10, 1982.

If we add to these chronological facts the historic and perhaps unprecedented character of the problems which the West faces (and which the holding of the NATO Summit in part reflects), the Versailles Summit acquires extraordinary significance for US foreign policy.

At Ottawa President Reagan re-established US leadership in the economic sphere by a forceful presentation and defense of his economic program. Despite sharp differences over interest rates, East-West trade, and North-South relations, the communique issued at Ottawa reflected all of the United States' major objectives -- an upbeat tone, no hint of protectionism, unified

and a Chairman's Summary on political issues that expressed an extraordinary degree of consensus among the allies on the nature of the Soviet threat and the Western response to it. Much of the "upbeat" tone emanating from Ottawa can be attributed to the President's forecast for vigorous growth in the US, with stable prices and strong dollar. While skeptical, the other participants adopted a "wait-and-see" attitude about the US program. The United States benefitted from an imaginative and attractive economic plan that had not yet been tested.

The follow-up of specific commitments made at Ottawa, both written and unwritten, has proceeded apace, despite some press commentary to the effect that Ottawa concealed real differences with rhetoric (see status report on Ottawa commitments at Annex A). To be sure, Ottawa did not resolve major differences on interest rates, fiscal and monetary policies and trade issues. But resolving issues in some definitive sense is not the appropriate measure of Summits. The agreements registered at Ottawa set the Summit countries on a useful, common course that has produced real progress in a number of areas.

Nevertheless, economic and political events since Ottawa have exacerbated certain alliance issues, particularly in macro-economic, trade and East-West relations. (for a more complete treatment of these events, see Annex B.) These events included:

-- onset of recession in the US

-- rise of unemployment throughout industrial world

(except Japan)

- persisting high US interest rates and value of the dollar
- projections of massive US budget deficits
- growing trade conflicts among US, Europe and Japan
- new socialist government in France implementing policies of demand stimulus, protectionism, nationalization of industry, and exchange rate intervention all of which are directly opposed to US economic preferences.
- imposition of martial law in Poland and tensions within the alliance over application of economic sanctions, particularly as the latter affect the Western Europe-Soviet Union gas pipeline project.

Issues at Versailles

Given these events, the President's success at Ottawa will not be easy to duplicate. The economic setting in the United States and Europe will not help very much. Even if economic activity is strengthening, unemployment in Europe will be at historic high levels, generating immense pressures for governments to "do" something. The poor macroeconomic setting will color trade, monetary and aid discussions. As importantly, unless the US economy is performing better than now expected by late spring, the skeptics at home and abroad will be lobbying strongly for agreement on policy actions not consistent with our economic program. Economic difficulties will spill over into the more political discussions as well -- coloring the European approach to East-West relations, including Poland.

Moreover, the United States has not yet developed an effective and convincing international dimension for its economic program. Persistent discussions of "coordination" and "cooperation" generate expectations of actions we may be willing to take either domestically or in the trade/monetary field, in order to better coordinate with our Summit partners. The Administration's economic philosophy leaves little room for overt coordination of short-term policy actions, but provides considerable opportunity for coordination of longer-range approaches to economic policy. Unfortunately, in the latter sphere, a wide gulf separates us from, for example, the French, with most of the others located on the intervening spectrum.

These factors all suggest that the challenge at Versailles will be greater than that faced at Ottawa. The newness is gone, the economic problems more severe. The preparatory process is under the control of the country (France) least sympathetic to our approach to economic policy.

The dominant issues at Versailles are likely to include, roughly in order of priority:

- macroeconomic issues, particularly massive doubts about US economic policies, which are unlikely to be muted as they were at Ottawa when the US program was still untested.
- trade issues, with the US trade balance and domestic economic circumstances (particularly threatened "reciprocity" type actions in Congress on autos, etc.)

increasing pressure on US officials to beat up on the Europeans and Japanese, at least making it less likely that we can resist European protectionist policies such as those advocated by the Community at Ottawa.

- East-West trade issues, depending heavily for their devisiveness on how the situation in Poland and the allied response evolve.
- Monetary issues, with the French government expressing a traditional French interest and a current policy interest, stemming from domestic inflationary policies, in intervention in exchange markets and more fixed exchange rates (as in EMS).
- Energy and north-South issues, less likely to be burning issues unless the discussions in New York on Global Negotiations polarize or new disruptions of energy supplies occur (e.g. Iranian attacks or subversion against Gulf oil producers).

US Objectives

In these circumstances, US objectives should include:

- to maintain and enhance the leadership role of the United States and President Reagan emerging from the Ottawa Summit;
- to focus attention on the broader political consequences of failing to keep economic differences in check;
- to strengthen Western unity in the face of unprecedented political (Poland) and economic (unemployment)

have suggested. We have already dispatched a note to the French suggesting that the February meeting of personal representatives and all subsequent meetings should involve full delegations (three members) as has been customary in the past (see Annex C). We have informed other summit personal representatives of this US proposal.

3. Substance

The United States owes the French a letter before the next preparatory meeting on February 27-28 outlining our suggestions on themes and issues at the Summit. A draft of this letter is attached at Annex D.

The general strategy followed in the preparation of this letter and in our current thinking about the Summit involves the following elements:

1. The French and perhaps other Summit partners will undoubtedly stress domestic economic issues -- unemployment, high interest rates, monetary policy -- with particular focus on US economic policy. The United States prefers to stress international issues -- trade, East-West relations, energy cooperation -- and to play out the ~~adverse~~ consequences of ~~adverse~~ domestic policies, such as subsidies, demand stimulus measures, etc. for multilateral trading and financial relations and ultimately for prospects of domestic recovery

- trade in its broadest sense as it relates to domestic adjustment policies, technological innovation and investment;
 - energy security building on sound domestic market policies (which have been achieved now in most Summit countries) and international cooperation to protect against vulnerability of supplies;
 - East-West economic relations.
2. In addition to formulating positive themes, the United States may have to undertake various steps to deflect or redirect the focus of other governments on US economic policy. Two possibilities are:
- initiatives to discuss US economic policy outside the Summit preparatory context, as in the case of the US invitation to the EC to hold a seminar on the President's new Economic Report after it is released in mid-February;
 - have the traditional macroeconomic paper done by the US drafted jointly with the UK so as to dwell less on US policy and more on how markets in other Summit countries as well as in the US work.
3. The United States may wish to view this Economic Summit together with the NATO Summit, as a critical crossroad for the Western Alliance. In this case, it would seek

- the first of a new round of Economic Summits;
- the Summit that set in motion the process of shaping a reinvigorated world economic system for the 1980s beginning on the trade area with the GATT Ministerial scheduled for November 1982;
- The Summit that reaffirmed fundamental Western values of political freedom and economic opportunity in the face of political/military challenge and economic failure on the part of Communist systems.

4.

However bold the United States chooses to be, several critical issues must be addressed in our own preparations (a discussion paper at Annex E develops these points in more detail).

- How do we take the offensive to "internationalize" the Administration's approach to economic policy? The emphasis, especially in Europe, on cooperation and coordination makes it difficult to agree within the Summit Seven on an international system that relies heavily on market decisions which are not overtly coordinated. A first requirement would be for us to give substance to our definition of

- What are our multilateral trade objectives that go beyond a list of sectors (services, investment, agriculture, etc.) where it is in our specific economic interest to push liberalization? Is there a theme for trade in the 1980s that has the mutually advantageous rationale of tariff reductions in the 1950s, 1960s and 1970s?
- Can we define a set of actions consistent with market policies to "energize" energy cooperation among the Western allies?
- How do we sustain the offensive represented by President Reagan's program for development at Cancun while recognizing budget constraints and constraints on US trade policy with the LDCs (which led recently to the Administration's ^{Agreement to} ~~compromise on~~ a more restrictive textile agreement)?

C. Preparations within the US Government

Preparation for Ottawa involved an elaborate inter-agency process spanning the bureaucracy horizontally and vertically, involving several Cabinet Councils. The input of this extensive process was disappointing in terms of the material supplied to the White House for eventual use by the President. While the scope of Summitry requires broad participation from the

guided, both procedurally and substantively, by a small coherent group which commands the confidence of the White House senior staff. This "Steering Group" should be involved in all aspects of Summit preparations and be granted priority attention when policy decisions are required. A group consisting of the President's Personal Representative (as Chairman) and representatives of the President's office, the Vice President's office, State, Treasury, CEA, NSC and USTR would seem appropriate and has been established under the Assistant Secretary of State for Economic and Business Affairs who is acting as personal representative.

By June, the durability of trade and investment relations among the Summit Countries will have been severely tested. We are likely to meet either in a relatively upbeat context, based on real progress toward resolving our problems, or in a very strained climate if such progress is not achieved. Over the next four months any of the following areas could cause serious confrontations among Summit participants and there is a real risk that several of the areas may get out of hand at once:

Improved Access to the Japanese Market - a serious concern for all other participants.

Further Sanctions Against the Eastern Bloc - a particularly critical issue between the United States and the Europeans.

Excessive Canadian Economic Nationalism (NEP/FIRA) - a major problem for the United States.

Excessive European Subsidies - the major problem for the United States and Canada is in third country agricultural markets; subsidized export credits and continued subsidies of steel and high technology also are a major U.S. concern.

Spreading European Import Restrictions - risk of difficulty between Europe and Japan in industrial products and Europe and the United States/Canada in agricultural products.

United States Trade Actions - the steel and agriculture cases will cause great consternation in Europe; reciprocity legislation will be a concern to all other participants.

The political management of these issues will be complicated greatly by adverse economic conditions, especially high unemployment in Europe and North America, and weak governments in Europe.

Since we cannot predict at this time how these problems will look at the time of the Summit, our preparations for the Summit should focus on less volatile, longer-term issues and initiatives in the trade and investment areas. In some instances, the Summit could address directly problems of concern primarily to the countries involved, and in others it should spur progress in other areas (e.g., GATT Ministerial). It is suggested that we establish the following as key trade and investment priorities for the Summit:

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- a strong push for assuring that the GATT Ministerial, in November, addresses unresolved and emerging problems in the trading system in a meaningful way. At a minimum the Ministerial should develop approaches with respect to safeguards, agricultural subsidies, services trade, and trade related investment issues.
- devising longer-range objectives and strategies for encouraging development and integration of LDCs into trading system, with special attention to getting NICs to provide improved market access for other LDCs; additional measures to improve our market access to LLDCs (e.g., enhanced GSP, preferential treatment under MFA); and improving investment climate in LDCs.
- establishing a multilateral forum for continuing dialogue on high technology issues including exchange of information on government policies and impact of those policies on others and ways to promote spread of technology to LDCs.

Other possible priorities that deserve consideration include launching an international review of the international trade and investment impacts of

- national tax practices
- the conditions in national capital markets and access of foreign firms to those markets
- national competition policies
- multinational corporations and investment policies

Most of the above topics were selected to emphasize the shift in our trade relations away from the traditional focus on trade in goods and tariff and nontariff barriers to such trade. It is clear that in the next 10-20 years we will have to focus to a much greater extent on other types of trade and trade barriers. This Summit could call attention to these shifts in emphasis, and launch or encourage a series of processes designed to adopt the multilateral framework accordingly.

We will need also to consider whether a more traditional affirmation of joint commitment to the multilateral trading system should be prepared for the Summit. Given present uncertainties, it is premature to make that decision--we must await further developments in next couple of months.

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CONFIDENTIALContext of the Energy Security Initiative

The following paper outlines some elements of an energy security package for consideration at the Versailles Economic Summit. The package and the timing of its implementation are directly linked to the debate over the Soviet Union-West European natural gas pipeline. Our approach to this issue, over the coming weeks, will largely determine how we should approach the subject of energy security at the Summit. If a positive solution could be found to the pipeline problem, then Versailles would be an excellent time to disclose the results. If on the other hand, no progress is made with the Allies, the pipeline debate could become a divisive element of the Summit meeting. The following three scenarios help clarify the nature of the problem:

Scenario I. The Europeans abandon the pipeline and the US contributes a major package of alternatives to assist the Europeans diversify their energy supplies from more reliable sources. This could include direct assistance (stepped up coal exports), as well as indirect means (i.e., deregulation of natural gas), which would reduce overall US energy demand on world markets and thus allow more opportunities for others. Consideration could also be given as to how lost European economic opportunities could be rechanneled into other projects (North Sea pipelines, Alaskan natural gas pipeline, etc.). Our effort, to be convincing, will have to be more specific than previous discussions we have had together on this subject. Measures are likely to be expensive and in some cases may require a change of US policy. Nevertheless, this scenario appears to be the best of any outcome albeit the most difficult to achieve. The following Summit paper emphasizes elements of this strategy.

Scenario II. The Europeans go ahead with the pipeline and the US tries to stop it, using any means at our disposal. If the US was successful in stopping or seriously delaying the pipeline -- which current analysis suggests may not be possible -- then overall reliance on the Soviet Union would be reduced and their hard currency earnings restricted. However, short term problems in the Alliance could be greatly exacerbated and cooperation in other areas of mutual concern (like TNF and COCOM) threatened. In addition, US industry would lose a significant amount of short term business and may sacrifice long term market opportunities.

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-2-

Scenario III. Despite our opposition, the Europeans go ahead with the pipeline; the US agrees not to extend existing sanctions and perhaps allows equipment already in Europe to be reexported. In return the Europeans agree to limit their imports to quantities provided for in current contracts. They also agree to put into place safety net measures (more gas storage, greater shut in capacity, increased dual-fired capacity, better integration of the grid, etc.) and to cooperate with the US in developing alternative sources of gas supply. The Europeans would probably be amenable to this approach. It would provide some added basic security, although our desire to stop the pipeline would not be fulfilled, and we would be seen to be backing away -- even if slightly -- from our Poland-related sanctions.

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CONFIDENTIALEnergy Security Theme PaperI. Overview

The events of the last decade have illustrated how integral a component energy is to Western economic performance. Achieving economic stability and renewing investor confidence requires a stable and secure energy situation, yet in this time of relative oil surplus, there is a tendency to be lulled into complacency. We should not miss the opportunity to take advantage of the current lull to reassess our experiences over the last few years and to take appropriate action to encourage a diversified and safe energy base necessary for long term economic stability.

Experience has shown that reliance on market principles is the most effective way to pursue long term structural adjustment of energy economies. For example, the price increases of the last few years have resulted in significant reduction in energy demand, illustrating in a most convincing way the importance of clear market signals to consumers. Today, we find ourselves in a much better situation with oil price relief brought about through a more reasonable approach to energy policy based on market principles. We should learn from this experience, build upon it and encourage our Allies to adopt pricing structures which reflect economic pricing, so that the transition to other sources of energy can be done in the most economical way possible.

At the same time that we pursue a strengthening of market forces it is also prudent to reexamine the topic of energy security. Energy security in the 1970s focussed primarily on protecting economics from severe oil supply disruptions and on promoting the need for alternatives. Our preparations, most notably in the IEA, arose out of the specific case of the 1973/74 oil embargo. Yet today energy risks have broadened: small oil shortfalls can have disproportionate effects on the overall economy; a dangerous blind spot has emerged with respect to the security implications of alternative sources of energy, some of which represent risks equal to that of insecure sources of oil supply (i.e., European dependence on Soviet gas); and there is concern that investments in key alternatives, such as coal and nuclear, are not being made at sufficient rates to induce a diversified energy economy. We see a need for the Allies to reassess their energy security measures --

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CONFIDENTIAL

-2-

collectively and individually -- and take appropriate action to build Western defenses.

II. Energy Security Objectives

The major long term objectives in promoting Western energy security should be twofold:

- encourage domestic alternatives so that oil imports can be reduced over time; and
- diversify energy imports, but not in such a way that just trades off security problems (i.e., European dependence on Soviet gas instead of Middle East oil).

The principal means of achieving this balance and therefore a more secure energy base is through the economic pricing of energy, which has proven to be effective in promoting new supplies and encouraging energy efficiency. As other fuels begin to displace oil, however, it is essential that the security implications of these new dependencies be carefully assessed and remedies sought -- especially if imports come from politically unstable or potentially unfriendly sources.

Over the short term energy security can be enhanced by an increase in oil and gas stocks, either in terms of inventories or shut in production capacity in OECD surplus countries. High levels of stocks provide an essential cushion of time which allows for more reflection and therefore more prudent decisions by governments during a crisis. Furthermore, if sufficient stocks exist, companies and consumers are less likely to engage in panic spot market buying which in the past has resulted in steep overall price increases. Stocks also have a deterrent effect on producers who may wish to use oil or gas as a political weapon.

III. Multilateral Energy Security Initiatives

The IEA Ministerial and Versailles Economic Summit offer an opportunity to expand the concept of energy security and set the framework for a redirection of industrialized countries' energy strategies. The following elements comprise an energy security package which could be considered by Ministers and Heads of State:

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-3-

Energy Pricing

- Agree to ensure that inadequate pricing structures do not impede energy development. For fuels where there is a world market, domestic prices should reflect international prices. In those areas where there are not world standards, the marginal replacement costs should serve as a guideline for pricing strategies.
- In those areas where national security could be threatened by potentially unstable sources of supply, consider imposing an import security fee to reflect the true cost of the imports and to help generate funds for security measures.

Oil

- Reaffirm the value of the IEA/EC Emergency Sharing System as the major mechanism for protecting Western economies against severe disruptions in oil supplies.
- Recognize that the opportunity exists over the next few years to increase strategic oil inventories.
- Continue discussions on use of oil stocks in supply disruption situations, but avoid taking binding decisions which could jeopardize the effectiveness of response in times of oil shortfall.

Natural Gas

- Agree to accelerate the pace of natural gas exploration, development and transportation systems in Summit countries; continue to discuss ways to stimulate exploration and development in other countries (e.g., Norway, Netherlands).
- Foster more efficient gas use through competitive (fuller cost) pricing.
- Reconsider the desirability of increasing dependence on insecure sources of supply outside the OECD area.

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-4-

- Given the expected increased weight of imported natural gas in European energy economies (even without Soviet gas), mandate the IEA and EC to explore and develop with utmost urgency means for enhanced security including increased storage facilities, built-in surge capacity to be tapped in times of emergency, better integration of the European gas grid, and more dual-fired capacity among large industrial users.

Coal

- Recognize that considerable progress has already been made by the private sector in expanding world coal trade.
- Underscore the importance of development of key infrastructure, including shipping and receiving ports (i.e., dredging of ports to handle large coal carriers).
- Stress the need for long term contracts to provide sufficient private investment to realize greatly expanded coal production and use.

Nuclear Energy

- Agree to exploit the full economic potential of nuclear power as an important component of energy diversification.
- Provided that preliminary studies support such a step, establish a high level group on nuclear energy within the framework of the IEA/NEA/OECD to assess the current state of nuclear development and key problems (financial, burdensome regulatory practices, back-end of the fuel cycle).
- Call for an international cooperative waste management project.

Cooperation in Energy Technology Development

- Maximize effective use of limited resources by reviewing how cost, task and facility sharing, on an international basis, could reduce costs of expensive national programs in fusion, nuclear safety and synfuels.

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-5-

IV. US Measures to Support International Initiatives

In support of these international efforts, the US might consider initiating a number of domestic measures. In some cases this would require significant policy choices and expenditures, including possible reversal of some recent decisions, that were made primarily on domestic policy grounds, without reference to energy security implications. A sample of these measures might include:

- Continue to fill the SPR at a healthy rate.
- Continue government support on a cost sharing basis with Port authorities to vigorously promote US coal exports; support enactment of legislation requiring an effective framework for financing port improvements.
- Offer to contribute to a major nuclear waste facility. This could alleviate significant US public concerns about nuclear waste buildup and facilitate an expanded nuclear power program.
- Consider means promote energy production in developing countries, by such means as increasing the multiplier effect of World Bank energy lending.

V. Other Summit Country Initiatives

Other Summit countries have considerable scope for improving their energy policies and security. The attached Annex includes a short check list of key energy policy and

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-6-

security deficiencies in Summit countries as reviewed by the IEA Group on Long Term Cooperation. In general, other Summit countries should be encouraged to:

- Strengthen gas security measures and impose an imported gas security fee (Germany, France, Italy).
- Increase European natural gas exploration and development (UK, EC).
- Increase oil stocks (Italy, Germany, France, Japan).
- Adopt energy pricing strategies which induce long term development of alternatives and better energy efficiency (Canada, Italy, UK).
- Induce greater substitution of coal for oil in the industrial and electrical sectors and improve infrastructure for importing coal (Germany, Italy, France, UK, Japan).
- Expand nuclear energy capacity (Germany, Italy, Japan).

Attachment:

Annex

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Summary of Summit Country Energy Deficiencies
(as reviewed by IEA/SLT)

Canada

- pace of deregulation of oil prices too slow (only 75% of world oil prices by 1985);
- need to increase oil and gas production, yet discrimination against foreign interest may impede this objective;
- need to accelerate development, use and export of coal.

Germany

- inadequate plans for natural gas security;
- nuclear power plant delays due to dwindling public confidence;
- need to stimulate domestic coal production and increase capacity to import and use coal;
- need to accelerate fuel switching policies to substitute imported coal for oil, and increase electricity use in the domestic and industrial sectors.

Italy

- inadequate plans for natural gas security;
- insufficient investment by ENEL (state electricity board) for coal and nuclear power plants;
- pricing of all fuels (except gasoline) and electricity well below world levels;
- need to expand infrastructure for gas and coal.

UK

- accelerate leasing and exploration so as to have a better estimate of potential oil and gas reserves; in light of this experience reconsider depletion policies;
- onerous and unstable tax and royalty regime has discouraged oil and gas exploration;

SECRET

-2-

- need to raise natural gas prices; eliminate BFG monopsony which keeps gas prices paid to producers at an uneconomically low level;
- encourage greater coal use, domestic production and imports.

US

- accelerate rate of decontrol of natural gas prices;
- expand coal export facilities (especially ports);
- reduce burdensome regulatory process and thereby reduce lead times for nuclear power construction;
- promote more vigorously synfuels and renewable energy sources.

France

- expectations for increases in domestic coal production may be too optimistic; need to more seriously consider imports;
- inadequate plans for natural gas security.

Japan

- encourage substitution for electricity, coal and gas for oil in industry and electricity and gas for oil in residential/commercial sector;
- expand use of coal and nuclear in electricity generation;
- extend and strengthen auto fuel economy standards.

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*ed this morning to Henry, etc.*EAST-WEST ECONOMIC RELATIONS
AT THE VERSAILLES SUMMITTab DBackground

The United States introduced East-West economic relations as a Summit topic at Ottawa. (We had also raised the issue at the 1975 Puerto Rico Summit, where we called prophetically and vainly for a coordinated allied approach to the problem of the rapidly rising Eastern debt.) The Ottawa meeting led to progress in the area of strategic trade controls, where a high-level meeting of COCOM in January launched a tightening of common allied restrictions on the export of militarily useful goods and technologies to the East. But in the other three areas in which we had sought better allied coordination -- contingency planning for economic measures in the event of a crisis in relations with the Soviet Union; joint planning to reduce Western economic vulnerability and enhance Western economic security; and developing common policies to improve Western influence and leverage -- progress has been slight or non-existent. On the contrary, the crisis in Poland has increased the risk that Western differences will be exposed and exploited by the Soviets. But the Polish situation, and particularly the Polish debt, has also created exceptional opportunities to forge coordinated allied positions that will greatly strengthen the Western hand and shift the risks of East-West trade from Western taxpayers to the Soviet Union.

US Objectives (to be sharpened after the Buckley mission)

- To address East-West trade finance and explore ways to shift costs and risks from West to East.
- To reduce harmful competition among Western countries for East bloc business.
- To draw attention to progress made in controlling trade in strategic goods and technologies and give continued impetus to the work of COCOM.

Discussion

The ability of Poland to acquire a hard-currency debt estimated at close to \$30 billion, and the inability of

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-2-

Poland to repay, contain lessons for Western governments and lenders that have not been learned.

In 1975, at the Puerto Rico Summit, U.S. officials expressed concern about uncoordinated Western lending to a Poland that then owed perhaps \$13 billion in hard currency and needed to spend about one-third of its hard-currency receipts on servicing that debt. In the six years since the Puerto Rico Summit, Western lending to the Soviet Union and the Eastern European members of COMECON has totalled perhaps \$60 billion. Pipeline loans will increase this figure substantially. The Economist estimates this lending as "probably a faster rate of grant-giving even in real terms than American Marshall aid to Europe in 1948-1952."

This huge transfer of resources has occurred without coordination among Western governments and without serious risk analysis. Loans have been heavily subsidized by Western taxpayers, either directly through extension of official credit at below-market rates or indirectly through official credit insurance and credit guarantees. With Western official institutions already facing heavy payouts on bad Polish loans (for example, the U.S. Commodity Credit Corporation has paid out \$ million, France's COFACE \$ million, and Germany's Hermes \$ million), and with Romania and even East Germany in extremely precarious financial condition, the folly of past practice has become evident. Even in terms of building markets for Western exports and employment, the returns on loans to the East are trivial in comparison to the returns on loans to the upper and middle tier of less-developed countries. And the anticipated political gains -- richer East-West links that liberalize the East, enhance security and cooperation in Europe, and strengthen the moderating elements in Soviet foreign policy -- have simply not materialized.

Under these circumstances, there is an urgent need for a joint assessment of the Western course. The competition among Western governments for Eastern markets has obviously been a losing game for all players, and it should stop. Western taxpayers should no longer be asked to underwrite the risks of East-West trade that arise from the gross economic failures and political turmoil of the Communist regimes. And Western governments should plan together now how to share the burdens of non-payment of bad loans already extended and avoid the worst consequences of East bloc defaults.

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-3-

The forum for such discussions is not of great consequence. Informal talks in a Paris-type creditors' club, in a G-5 setting among financial officials, in periodic Sherpas meetings, or elsewhere would serve our purpose well.

Although our presentation at Versailles should concentrate on the debt, we should not neglect to follow-up on the COCOM high-level meeting that grew out of the Ottawa Summit. That meeting produced a consensus among the NATO countries and Japan for tightening controls on "really strategic" trade with the Soviet Union (while removing from the COCOM embargo items no longer of strategic significance), closing embargo gaps and loopholes, and improving the enforcement and administration of the embargo. But if high-level attention to COCOM matters begins to flag, the momentum of the high-level meeting will soon be dissipated. At Versailles, we should stress the need to translate the conclusions of the high-level meeting into actual changes in the embargo lists and procedures; call for action on U.S. proposals already on the table; and ask that adequate resources (including defense and intelligence experts) be made available for COCOM work.

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C O N F I D E N T I A L STATE 046871

EXDIS, USEC ONLY
E.O. 12065: RDS - 2/20/88 (HORMATS, ROBERT)

TAGS: ECON, ETRD

SUBJECT: VERSAILLES SUMMIT: MESSAGE FOR JACQUES ATTALI

1. C - ENTIRE TEXT.

2. FOR PARIS. PLEASE DELIVER THE LETTER (IN PARA. 4) FROM
ROBERT HORMATS TO JACQUES ATTALI.

3. FOR OTHER ADDRESSEES. PLEASE DELIVER THE TEXT OF THE
LETTER IN PARA. 4 TO YOUR HOST GOVERNMENT'S PERSONAL
REPRESENTATIVE FOR THE ECONOMIC SUMMIT, UNDER COVER OF A
NOTE INFORMING THE PERSONAL REPRESENTATIVE THAT THE LETTER
CONTAINS THE USG VIEWS ON ISSUES AND TOPICS FOR THE
VERSAILLES SUMMIT AND HAS BEEN DELIVERED TO JACQUES ATTALI
AS AGREED AT THE DECEMBER MEETING OF PR'S.

4. BEGIN TEXT.

DEAR JACQUES:

IN THIS NOTE I WOULD LIKE TO GIVE THE VIEWS OF THE U.S.
ON THE OVERALL CONCEPT, THE THEMES AND THE AGENDA FOR THE
VERSAILLES SUMMIT, WHICH EACH PERSONAL REPRESENTATIVE
AGREED TO PROVIDE PRIOR TO OUR NEXT MEETING ON FEBRUARY 27-

28.

THE ANNUAL ECONOMIC SUMMITS HAVE BECOME INVALUABLE NOT
ONLY AS A MEANS OF DEALING WITH THE PRIORITY POLICY
ISSUES CONFRONTING THE INDUSTRIALIZED DEMOCRACIES. BUT
ALSO AS A MEANS OF INSPIRING CONFIDENCE THAT WE SHARE
COMMON OBJECTIVES AND WILL COOPERATE TO ATTAIN-THEM -
DURING A PERIOD OF INTENSE CHANGE AND UNCERTAINTY-THAT

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NATIONAL SECURITY COUNCIL MESSAGE CENTER

PAGE 02 OF 05 SECSTATE WASHDC 6871

DTG: 230114Z FEB 82 PSN: 026491

HAS CHARACTERIZED THE POST-1973 INTERNATIONAL ECONOMIC SYSTEM. BY MEETING TOGETHER ON AN ANNUAL BASIS, OUR LEADERS PROJECT TO OUR PEOPLE AND THE WORLD THEIR INDIVIDUAL AND COLLECTIVE DETERMINATION TO PRESERVE AND ENHANCE THE ECONOMIC PROSPERITY AND SECURITY OF THE INDUSTRIALIZED DEMOCRACIES. IN THIS SENSE, THE ECONOMIC SUMMITS ADDRESS MUCH MORE THAN ECONOMICS, EVEN THOUGH THIS REMAINS THEIR PRINCIPAL SUBJECT.

THE MOST IMPORTANT FUNCTION IS TO ALLOW FOR A THOROUGH AND FAR-REACHING EXCHANGE OF VIEWS AMONG LEADERS. EACH LEADER GAINS A BETTER UNDERSTANDING OF THE BROAD POLITICAL AND ECONOMIC PERSPECTIVE FROM WHICH HIS OR HER COLLEAGUES ARE APPROACHING THEIR RESPONSIBILITIES. THE RESULT MAY NOT ALWAYS BE CONCRETE DECISIONS -AT THE SUMMIT. INDEED, THE DISCUSSIONS WILL BE MORE RELEVANT AND SIGNIFICANT IF THE LEADERS DO NOT HAVE TO SPEND TIME ON DETAILED NEGOTIATION OF SPECIFIC POINTS OR ISSUES. - THE EXCHANGE CAN AND DOES PERMIT THE FORMULATION OF COMMON VIEWS EXPRESSED IN THE COMMUNIQUE AND BEYOND THAT INFLUENCES THE WAY IN WHICH EACH LEADER MAKES DECISIONS ONCE HE OR SHE RETURNS HOME. NATIONAL POLICIES ARE BETTER INFORMED AND MORE SENSITIVE TO INTERNATIONAL CONSIDERATIONS AS A RESULT.

THE SERIOUS ECONOMIC PROBLEMS WE FACE MAKE THIS SUMMIT PARTICULARLY IMPORTANT. A COMMON SENSE OF PURPOSE, A WILLINGNESS TO BREAK AWAY FROM PESSIMISTIC ATTITUDES TOWARDS OUR PROBLEMS, A SOUND APPROACH TO RESOLVING THEM, AND THE ESTABLISHMENT OF A POSITIVE COURSE WHICH WE CAN PURSUE TOGETHER IN SUCH AREAS AS TRADE AND ECONOMIC GROWTH CAN STRENGTHEN THE ABILITY OF EACH OF OUR LEADERS TO SUCCESSFULLY OVERCOME CURRENT ECONOMIC DIFFICULTIES. ON THE OTHER HAND, ABSENT SUCH PROGRESS, THESE SAME PROBLEMS CAN IMMOBILIZE OUR GOVERNMENTS AND HEIGHTEN INTERNATIONAL FRICTIONS. WE MUST RETAIN THE CONFIDENCE THAT OUR SOCIETIES CAN MEET THE TASK OF

REVITALIZING GROWTH AND PROSPERITY IN THE WESTERN WORLD.

IN ADDITION, POLITICAL DISCUSSIONS AT THE SUMMIT WILL BE IMPORTANT TO THE OVERALL TONE AND FRAMEWORK FOR CONSIDERING ECONOMIC ISSUES. THIS IS PARTICULARLY TRUE THIS YEAR AS EVENTS HAVE THROWN THE SPOTLIGHT ON OUR SECURITY CONCERNS. WE SHOULD CONSOLIDATE OUR CONSENSUS AND MOVE FORWARD ON OUR COMMON RESPONSE TO POLAND, AFGHANISTAN AND BROADER RELATIONS WITH THE SOVIET UNION. THESE DISCUSSIONS CAN CONTRIBUTE TO A SENSE OF COMMON PURPOSE AMONG OUR NATIONS AND CAN HIGHLIGHT THE IMPORTANCE OF OUR POLITICAL ALLIANCES. WE WILL ALSO WISH TO DISCUSS MAJOR REGIONAL ISSUES AND ANY OTHER TIMELY CONCERNS. IT WOULD BE MOST USEFUL TO SUMMARIZE THESE DISCUSSIONS IN A CHAIRMAN'S SUMMARY, AS WE DID SO EFFECTIVELY AT OTTAWA.

AT VERSAILLES, OUR LEADERS WILL WANT TO HAVE A THOROUGH AND CANDID EXCHANGE ON MACROECONOMIC POLICY ISSUES. BUT WE CAN DO MORE THAN THAT: OUR LEADERS SHOULD DISCUSS HOW BEST TO WORK TOGETHER TO IMPROVE ECONOMIC PERFORMANCE, IN THE FRAMEWORK OF A COMMON VIEW OF OUR BASIC ECONOMIC OBJECTIVES.

ALL OUR COUNTRIES HAVE THE SAME OBJECTIVES: VIGOROUS GROWTH, LOW INFLATION, REDUCED UNEMPLOYMENT, AND GREATER STABILITY IN FOREIGN EXCHANGE MARKETS. WHILE WE MAY DIFFER FROM TIME TO TIME ON HOW BEST TO ATTAIN THESE OBJECTIVES, WE RECOGNIZE THAT WE CAN ATTAIN THEM BETTER BY WORKING TOGETHER THAN AT CROSS PURPOSES. IN THIS SPIRIT, WE MUST REMAIN SENSITIVE TO THE CONSEQUENCES OF THE DIFFERENCES AMONG OUR DOMESTIC POLICIES AND

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PAGE 03 OF 05 SECSTATE WASHDC 6871

DTG: 230114Z FEB 82 PSN: 026491

RECOGNIZE THAT THESE DIFFERENCES MUST BE KEPT WITHIN REASONABLE LIMITS IF STABILITY IS TO RESULT.

BEYOND THE IMMEDIATE ISSUES OF DOMESTIC ECONOMIC POLICY, THE UNITED STATES BELIEVES THAT THREE THEMES, IN PARTICULAR, ARE CRITICAL FOR THE LONGER-TERM COURSE WE SEEK TO CHART: MULTILATERAL TRADE RELATIONS, ENERGY SECURITY, AND EAST-WEST ECONOMIC RELATIONS.

TRADE. THE POST-WAR MULTILATERAL TRADING SYSTEM STANDS AT A CRITICAL THRESHOLD. -SERIOUS DOMESTIC ECONOMIC PROBLEMS, AND THE RESULTING INCREASE IN SENSITIVITY TO COMPETITION, ARE PROPELLING COUNTRIES TOWARD INCREASINGLY PROTECTIONIST POLICIES. THESE PROTECTIONIST POLICIES, IN TURN, MISALLOCATE RESOURCES AND REDUCE NATIONAL ECONOMIC EFFICIENCY AND WELL-BEING. IN THESE CIRCUMSTANCES, THE REDUCTION OF TARIFF BARRIERS IS NO LONGER THE KEY. TARIFF RATES ON MOST MANUFACTURED PRODUCTS ARE AT HISTORICALLY

LOW LEVELS. NON-TARIFF BARRIERS, BY CONTRAST, HAVE GROWN AND NOW REPRESENT SERIOUS OBSTACLES. YET, EXPERIENCE IN DEALING WITH THESE BARRIERS IN THE MANUFACTURING SECTOR OR IN OTHER SECTORS SUCH AS AGRICULTURE, INVESTMENT AND SERVICES, ARE MUCH MORE LIMITED. WE HAVE ONLY BEGUN TO ESTABLISH THE PRINCIPLES THAT APPLY IN THIS AREA AND THUS FAR HAVE NOT FOUND A CLEAR AND SIMPLE RALLYING POINT FOR NEW RULES AND A REDUCTION OF DISTORTIONS THAT ARE IN THE INTEREST OF ALL.

AFTER WORLD WAR II, WE FOUND RATIONAL, PREDICTABLE AND EQUITABLE RULES TO DISCIPLINE TRADE POLICIES AT THE BORDER. CAN WE NOW FIND APPROPRIATE INTERNATIONAL RULES TO HARMONIZE OR MODIFY POLICIES ADOPTED FOR ESSENTIALLY INTERNAL REASONS THAT NEVERTHELESS HAVE AN ADVERSE IMPACT ON THE MOVEMENT OF GOODS, SERVICES, AND CAPITAL ACROSS OUR BORDERS? EVEN AS WE INSIST ON FULL IMPLEMENTATION OF THE RESULTS OF THE TOKYO ROUND, WE NEED TO START DEVELOPING NEW UNDERSTANDINGS AND RULES TO DEAL WITH NEW PROBLEMS.

THE GATT MINISTERIAL TAKES PLACE IN NOVEMBER OF THIS YEAR. THE SUMMIT COUNTRIES SHOULD CONSIDER MAKING THE POLITICAL COMMITMENT TO PREPARE FOR AND USE THIS MINISTERIAL TO BEGIN A PROCESS OF INVENTORING, ANALYZING, AND ENGAGING IN SERIOUS ACTION-ORIENTED DISCUSSION OF THE NEW THREATS AND OPPORTUNITIES CONFRONTING THE INTERNATIONAL TRADING SYSTEM IN SUCH AREAS AS INVESTMENT AND RELATED TRADE DISTORTIONS; TRADE IN SERVICES; THE TRADE IMPLICATIONS OF RAPID TECHNOLOGICAL INNOVATION; TRADE WITH DEVELOPING COUNTRIES AND THE THORNY QUESTION OF SAFEGUARDS AND STRUCTURAL ADJUSTMENT WHICH MUST BE ADDRESSED IF WE ARE TO SHARE WITH DEVELOPING NATIONS THE FULL BENEFITS OF, AND RESPONSIBILITY FOR, THE INTERNATIONAL TRADING SYSTEM; AND TRADE IN AGRICULTURE FOR THE MUTUAL BENEFIT OF PRODUCERS AND CONSUMERS.

WE BELIEVE IT PARTICULARLY APPROPRIATE FOR THE VERSAILLES SUMMIT TO DEVELOP THE THEME OF TECHNOLOGICAL INNOVATION, AS YOU SUGGESTED, AND ITS FUNDAMENTAL IMPLICATIONS FOR EMPLOYMENT AND INTERNATIONAL COMPETITIVENESS.

ENERGY SECURITY. AFTER TWO SHATTERING OIL PRICE SHOCKS, ENERGY MARKETS HAVE STABILIZED. THIS IS TRUE, IN LARGE PART, BECAUSE MOST COUNTRIES NOW PERMIT THE MARKET PRICING OF ENERGY SUPPLIES. THE CURRENT WORLD OIL SURPLUS IS A WELCOME RESULT OF MARKET FORCES; WE NEED TO CONTINUE TO REMOVE REMAINING OBSTACLES TO THE EFFICIENT PRICING OF ENERGY SUPPLIES AND PRODUCTS.

THE IMPROVED MARKET SITUATION, HOWEVER, SHOULD NOT LEAD TO

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NATIONAL SECURITY COUNCIL MESSAGE CENTER

PAGE 04 OF 05 SECSTATE WASHDC 6871

DTG: 230114Z FEB 82 PSN: 026491

COMPLACENCY. WE FACE CONTINUING AND STILL DIFFICULT THREATS. THE THREAT OF OIL DISRUPTIONS CONTINUES, INTENSIFIED BY INTRA-REGIONAL WARFARE BETWEEN IRAQ AND IRAN, AND CONTINUING ARAB-ISRAELI TENSIONS. THERE ARE OTHER SOURCES OF INSTABILITY AS WELL:

-- THE RISK THAT, WHILE WE BENEFIT FROM SECULAR DECLINE IN REAL OIL PRICES, THE PRESENT DOWNTURN IS TEMPORARY AND MAY UNDERCUT CONSERVATION AND THE DEVELOPMENT OF ALTERNATIVE ENERGY SOURCES.

-- THE VULNERABILITY ASSOCIATED WITH LARGE-SCALE DEPENDENCE ON RELATIVELY LESS FLEXIBLE SUPPLIES OF NATURAL GAS FROM POTENTIALLY UNRELIABLE SOURCES -- THE SOVIET UNION, OPEC COUNTRIES, ETC.

-- THE PRESSURE OF ANTI-NUCLEAR SENTIMENT IN OUR DEMOCRACIES WHICH SEVERELY IMPEDES THE GROWTH OF ONE OF OUR MOST IMPORTANT SOURCES OF FUTURE ELECTRIC POWER.

TO RESPOND TO THIS BROADER ARRAY OF CONCERNS, THE WEST SHOULD RALLY TO REVITALIZE COOPERATION ONCE AGAIN IN ENERGY SECURITY. THIS TIME, HOWEVER, THE APPROACH SHOULD EMPHASIZE VARIOUS ENERGY SECTORS (NOT ONLY OIL) AND SHOULD OPERATE THROUGH DOMESTIC AS WELL AS MULTILATERAL INITIATIVES. THE SUMMIT LEADERS MIGHT CONSIDER HOW TO STRESS THE NEED TO CONTINUE THE PROGRESS IN REDUCING CONSUMPTION AND STIMULATE NEW PRODUCTION AND HOW BEST TO ENHANCE OUR MUTUAL ENERGY SECURITY.

EAST-WEST ECONOMIC RELATIONS. ECONOMIC RELATIONS BETWEEN EAST AND WEST ARE A POTENTIALLY DIVISIVE ISSUE BETWEEN US. LAST YEAR, AT THE OTTAWA SUMMIT, THE UNITED STATES TOOK A CAREFULLY DIFFERENTIATED POSITION ON THIS ISSUE. WE NOTED THAT ECONOMIC RELATIONS ARE INEVITABLY AFFECTED AND CONSTRAINED BY THE NATURE OF BROAD POLITICAL AND STRATEGIC RELATIONS BETWEEN EAST AND WEST. WE FURTHER NOTED THAT THESE ECONOMIC CONTACTS CANNOT BE ALLOWED TO UNDERMINE THE COLLECTIVE POLITICAL WILL OF THE WEST TO REACT TO THE HEAVY-HANDED BUILDUP AND USE OF INTIMIDATION BY THE SOVIET UNION.

WE CALLED FOR GREATER CONSULTATIONS AMONG WESTERN GOVERNMENTS TO ENSURE THAT WE UTILIZE OUR OWN ECONOMIC AND FINANCIAL POWER VIS-A-VIS THE EAST IN WAYS THAT ENHANCE OUR COMMON GOAL.

MUCH HAS HAPPENED SINCE THEN. WE SHOULD CONTINUE TO WORK TOWARD COMPLEMENTARY AND REINFORCING ECONOMIC AS WELL AS POLITICAL ACTIONS TO SIGNAL DISAPPROVAL IN THE STRONGEST POSSIBLE WAY OF CURRENT POLICIES OF THE POLISH GOVERNMENT AND, AS THE ULTIMATE SOURCE BEHIND THESE POLICIES, THE SOVIET UNION. IN THE LONGER TERM, WE MUST STRENGTHEN CONTROLS ON STRATEGIC EXPORTS AND BUILD ON THE EXCELLENT RESULTS OF THE HIGH-LEVEL COCOM MEETING IN JANUARY. FURTHER, WE MUST SORT OUT PATIENTLY AND PRUDENTLY OUR DIFFERENCES ON ISSUES OF DEPENDENCE AND VULNERABILITY VIS-A-VIS SOVIET ENERGY SUPPLIES AND MARKETS. AND WE MUST CONTINUE TO COORDINATE OUR POLICIES ON FINANCIAL EXPOSURE AND FURTHER ECONOMIC RELATIONS WITH POLAND, OTHER GOVERNMENTS OF EASTERN EUROPE, AS WELL AS THE SOVIET UNION.

THE UNITED STATES IS ALSO MINDFUL OF THE NEED TO SUSTAIN AND DEEPEN THE "SPIRIT OF CANCUN" IN RELATIONS BETWEEN SUMMIT AND DEVELOPING COUNTRIES. IN TRADE AND ENERGY SECURITY, THE CONCERNS OF DEVELOPING NATIONS SHOULD FIGURE PROMINENTLY. THEY HAVE YET TO BENEFIT FULLY FROM, OR CONTRIBUTE AS ACTIVELY AS WE WOULD LIKE TO, THE POSTWAR TRADING SYSTEM, AND IT WOULD BE CATASTROPHIC FOR THE FUTURE

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PAGE 05 OF 05 SECSTATE WASHDC 6871

DTG: 230114Z FEB 82 PSN: 025491

OF THESE COUNTRIES IF THE DEVELOPED COUNTRIES NOW TURNED THEIR BACKS ON THE PURSUIT OF FREE TRADE. WE AND THEY NEED TO FIND WAYS OF STRENGTHENING THE TRADING SYSTEM IN ORDER TO PRESERVE ITS OPENNESS. IN ENERGY, WE SHOULD DISCUSS WAYS TO ACCELERATE THE EFFORTS OF THE WORLD BANK AND BILATERAL ASSISTANCE PROGRAMS TO CATALYZE THE FLOW OF PRIVATE CAPITAL TO DEVELOPING COUNTRIES. VITAL TO THE OVERALL GROWTH PROSPECTS OF THE DEVELOPING COUNTRIES, ESPECIALLY IN THE AREAS OF TRADE AND ENERGY, IS THE ROLE OF PRIVATE INVESTMENT.

THE VERSAILLES SUMMIT IN A SENSE BRINGS US BACK TO RAMBOUILLET. OUR CENTRAL PURPOSE TODAY WAS ALSO STATED THEN: "WE INTEND TO PLAY OUR OWN FULL PART AND STRENGTHEN OUR EFFORTS FOR CLOSER, INTERNATIONAL COOPERATION AND CONSTRUCTIVE DIALOGUE AMONG ALL COUNTRIES." THE UNITED STATES LOOKS FORWARD TO WORKING CLOSELY WITH OUR PARTNERS TO ACHIEVE THESE ENDS.

I AM SENDING A COPY OF THIS NOTE TO OUR OTHER COLLEAGUES.

SINCERELY,

BOB HORMATS
HAIG
BT

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EXECUTIVE SECRETARIAT**Routing Slip**

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